

As a result, the incorporation of moving average productivity offset calculation eliminates the primary rationale for earnings sharing as a flow-through of productivity gains.³⁰

Issue 3b:

If we adopt moving average X-Factors, how many years of data should be included in the average?

The length of the moving average should be long enough to include periods of both overall economic expansion and economic contraction. This requires that the length be determined with an eye toward the average length of the U.S. business cycle, which has averaged about five years since WWII.³¹ Observed productivity growth can be somewhat volatile due to a number of factors. These factors include: the "lumpiness" of the large capital investments typical of the LEC industry; the cyclical nature of both the U.S. economy and the LEC industry; and the inherent volatility of productivity caused by external factors beyond LEC management control, including the effects of regulation, technology, related industry trends and competition. A moving average serves to dampen volatility in individual annual growth rates.

Issue 3c:

If we adopt moving average X-Factors, should there be any lag? If so, how long should that lag be?

The lag associated with incorporating a moving-average X-factor should be as short as is practical. If the Commission adopts the improved simplified Christensen TFP

³⁰ See Fourth FNPRM, paras. 96-97.

³¹ The National Bureau of Economic Research (NBER) is the official arbiter that determines the peaks and troughs of the U.S. economy business cycles. The peaks and troughs are published by the U.S. Department of Labor, Bureau of Labor Statistics in the Monthly Labor Review and the U.S. Department of Commerce, Bureau of Economic Analysis in the Survey of Current Business.

approach, a lag of as little as six months after the close of year might be possible, but a longer lag may be more practical. The ARMIS data relied upon by the Christensen approach is already filed on March 31 or April 1 of the following year. BLS price index data may also be available on such short lags. The LECs' annual access tariff filings, currently filed on about April 1 each year, can and should be moved back to 60-days notice filings because there is no longer any need to accommodate a LEC access charge flow-through filing by AT&T in the middle of the LEC price cap filing schedule. To the extent that the study methods and filing process are automated to the point that disputes are at a minimum, a two-month period could be sufficient to resolve any questions about the updated X-factor prior to the LECs' annual filings. Further, USTA has prepared a TFP Review Plan (TFPRP) that is fashioned after the Commission's current Tariff Review Plan (TRP) used to evaluate the LECs' annual filings. The TFPRP could also facilitate a short lag.

Issue 3d:

If we adopt a moving average X-Factor based on TFP, should there be one moving average for the X-Factor, or separate moving averages for distinct components of the TFP calculation?

The Commission should not adopt separate moving averages for distinct components of the TFP calculation. The Christensen TFP method already includes moving averages where appropriate in the calculation of the annual TFP growth estimates.³² Use of

³² The Christensen simplified method utilizes a three-year moving average on the estimated cost of capital and in the calculation of the expected capital gain associated with holding capital. This approach in calculating the rental price of capital is based on the evaluations of Harper, Berndt and Wood. See Christensen Response, p. 22, footnote 22.

additional moving averages or different moving averages for different components in the calculation of a TFP-based productivity offset would not be appropriate.

Issue 3e:

If we adopt fixed X-Factors, on what time period should the studies to determine the X-Factor be based?

As described above, SWBT does not recommend the use of a fixed X-factor in the permanent price cap plan. A moving average approach would facilitate the elimination of earnings sharing, make the plan more adaptive to changing conditions and eliminate the need for frequent performance reviews.

Issue 3f:

If we adopt fixed X-Factors, when should the next performance review be scheduled?

As, stated above, SWBT does not support the adoption of a fixed X-factor. The Commission could conclude that the use of fixed a X-factor might increase the need for more frequent formal performance reviews. SWBT's reasons for opposing fixed X-factors are the time and effort that must be expended during performance review and the significantly increased risk and uncertainty that reviews present.

To the extent that conditions may change over time a moving average picks up changes in an orderly and even-handed manner. Parties to the formal performance review process, however, are not always orderly and even-handed in their recommended changes to a regulatory plan. Thus, from a public interest perspective, the moving average approach is the preferable alternative to the extensive and exhausting process of formal performance reviews. As a result, the Commission should not establish a performance review schedule based on the perceived need to set a fixed X-factor.

K. Number of X-Factors

Issue 4:

Should there be multiple X-Factors in the long-term price cap plan and, if so, how many should there be and how should they be determined?

The elimination of earnings sharing should be the paramount concern as the Commission considers multiple X-factors in the LEC price cap plan.³³ A fundamental reason that sharing should be eliminated is to provide proper incentives for investment in the regulated telecommunications sector. This point was made extensively in the record in this docket during 1994. Earnings sharing represents a significant drain on the cash flows expected from new services. Elimination of sharing will provide LECs with incentives that are closer to the incentives currently available to other telecommunications providers.

In addition, the elimination of earnings sharing makes it possible for individual services and markets to be subsequently removed from price cap regulation without requiring the adoption of new, but arcane cost allocation rules for their removal. Maintaining old or creating new cost allocation rules runs contrary to the prevailing trends in telecommunications. The elimination of sharing promotes competition, while the retention of earnings sharing is entirely inconsistent with the rapid development of competition.

Economic theory and public interest arguments support using only one X-factor. That X-factor would be determined as the average of the TFP results for all price cap LECs, using the TFP methodology presented by Christensen.

³³ SWBT, USTA, the Commission itself and many other parties have identified many of the disincentives and other reasons why cost-plus regulation should be eliminated. Earnings sharing is merely a hybrid form of cost-plus regulation.

If the apparent heterogeneity of LECs must be addressed by providing for the possibility of different levels of "X" for different LECs, then the Commission might consider whether it could still apply only one X-factor (or X-factor method) to any specific LEC and yet have a different X-factor for a meaningful subset of the price cap LECs.³⁴

Such an approach would involve some aspect of assignment of "X" to individual LECs, but should only be very generally and lightly applied. Assignment should never be so specifically applied as to prescribe individual LEC X-factors, a result which is essentially equivalent to the reimposition of cost-based ROR regulation.

Caution is required on other fronts as well. The Commission should not classify individual LECs into achieved X-factor categories based on their recent historical productivity performance.³⁵ For the Commission's regulation of the price cap LECs to be truly "incentive" regulation, efficiency incentives must exist to encourage the firms' management to make the correct and tough choices. If LECs are permanently classified into categories based on their specific past productive behavior, the Commission is, in essence, recapturing all, or possibly more than all, of the financial benefits of past efficiencies, penalizing the very behavior that the Commission wishes to encourage. Creating such "sticks" completely eviscerates the "carrots"

³⁴ For example, one X-factor (the results from the simplified Christensen study) might apply to the largest LECs (for example, LECs with more than \$3 billion in total regulated LEC revenue) and another factor (the simplified Christensen study results minus 1.5 %, for example) might apply to the smaller LECs (for example, all LECs not subject to ROR regulation with total regulated revenues less than \$3 billion). This distinction would include approximately nine LECs in the "larger LEC" group.

³⁵ The use of data from the TFPRP to infer individual company TFP results is inappropriate because theoretical assumptions underlying the computation of capital input do not remain valid when applied to data for a single firm.

of the plan. Thus, so long as there are market areas or service segments that have not achieved the fully competitive status which represents the regulators' ideal, there must remain in the regulatory paradigm sufficient financial incentives for shareholders to encourage efficient behavior, if, in fact, efficient behavior is to be fostered.

While SWBT does not oppose different LECs having differing X-factors as noted above, SWBT is opposed to multiple X-factors in the event that the Commission concludes retention of earnings sharing is the only meaningful way to "force" LECs to "choose" the X-factor option that most closely matches each LEC's internal productivity potential. In such a situation, the Commission's desire to extract from each LEC the absolute maximum that it can results in the loss of significant consumer benefits in the form of foregone investments in new services and efficiency generating technologies. On net, consumers could stand to lose much more than the current access customers might appear to gain.

Also, SWBT recommends that the Commission not establish a lower X-factor based on competitive showings. The fundamental relationship that should be the focus of the permanent LEC price cap plan is the fact that greater pricing flexibility must be associated with greater degrees of competition. Linking adjustments in the X-factor to the degree of competition will inappropriately dilute the necessary components of the plan.³⁶ The Commission should

³⁶ See SWBT Comments on Second FNPRM, filed December 11, 1995, p. 9. As explained above, the Commission should not adopt a system of multiple X-factors. For these reasons, the Commission should not adopt multiple X-factors based upon the level of competition as contemplated in the questions raised in issues 19a-c of the Second FNPRM, and designated for response with the Fourth FNPRM in the Order on Motion for Extension of Time, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, (DA 95-2349) (Com. Car. Bur. released November 13, 1995).

focus on encouraging efficient investment regulatory parity, including appropriate pricing flexibility.

If a lower "X" is tied to a competitive showing, the degree of pricing flexibility appropriate to the competitive showing could be incorrectly curtailed. For example, a showing that effective competition exists in a market segment should result in that segment being regulated on a streamlined basis, i.e., removed from price cap regulation, not merely awarded a lower "X" without significantly increased pricing flexibility. Thus, focussing on options that grant a lower "X" to some segment of LEC services based on a competitive showing fails to recognize the absolutely critical importance that pricing flexibility and general regulatory flexibility play in delivering benefits to customers.

Also, to the extent that a LEC market segment or geographic area has already met (or can meet) a competitive showing threshold, those services should be removed from price cap regulation. As a result, no productivity offset would apply to that segment or area. While SWBT's proposal essentially allows for a relaxation of the X-factor constraint based on competition (because under streamlined regulation there is no price cap or productivity offset), SWBT's proposal more appropriately focuses on the relationship between the degree of competition and the degree of pricing flexibility as the key. Thus, LEC service areas that are effectively competitive should not be price cap regulated.

LECs should not be required to "buy" pricing flexibility by requiring a higher "X."³⁷ The greatest degree of pricing flexibility is needed where competition is greatest. In

³⁷ Fourth FNPRM, para. 118.

an effectively competitive market, full contract pricing flexibility is definitely warranted.³⁸ As barriers to entry have fallen, competitive supply exists and customers are willing and able to seek competitive alternatives -- the incumbent carrier should have the ability to deaverage prices, structure customized offerings in response to requests for proposal, and generally set any prices at any levels as long as they make some contribution to common costs.³⁹ This type of fundamental and necessary pricing flexibility should not be held hostage by attempts to extract high "X" values from the LECs.

Finally, an industry average X-factor should not be used as the minimum X-factor in a set of multiple options. There is no rationale for the average achieved LEC performance being used as a minimum X-factor expectation for the future. The increasing loss of high-margin, high-density areas of business to competitors will make sustaining the average of recent historical LEC performance a very ambitious objective for the services and market areas remaining under price cap regulation.

L. Sharing Requirements and Alternatives

Issue 5a:

If we establish a plan in which LECs have a choice of X-Factor, what incentive mechanism should be used to encourage each LEC to choose an X-Factor that is appropriate for its economic circumstances? Is it possible to develop an incentive mechanism other than one based on sharing?

³⁸ For example, in the railroad industry, a larger portion of all pricing is individually contracted, compared to purchases that are governed by averaged tariffs subject to price cap regulation.

³⁹ See SWBT Comments on Second FNPRM, filed December 11, 1995, pp.9-14.

Paragraph 199 asks if sharing should be used as an incentive mechanism to encourage LECs to adopt given X-factors. Sharing is not a proper incentive mechanism in a price cap plan; it is clearly a disincentive and should be eliminated for incentive regulation altogether.

ROR regulation and earnings sharing do not create proper incentives; they create strong harmful disincentives. The regulatory paradigm should not cause each individual LEC (or LEC tariff entity) subject to price cap regulation to "self-select" an X-factor that is viewed to be more appropriate for itself at any point in time than a broadly-defined industry average target.⁴⁰ It is not possible to use mechanisms of ROR regulation, which the Commission has clearly determined does not contain sufficient incentives for efficiency, to create proper efficiency incentives in a permanent price cap plan.

In the context of the First Report and Order in this docket, the Commission imposed a much more restrictive form of ROR regulation than was previously imposed on price cap carriers. The Commission ordered essentially a two-track plan -- one with very tight earnings sharing constants and one with a significantly higher productivity offset and no earnings sharing.⁴¹ The sharing "track" severely tightened the sharing ranges, reducing the width of the 50/50 sharing range from 400 basis points to a mere 100 basis points. It is important to recall from the history of ROR regulation that ranges in the 25, 40 and 50-basis point range were

⁴⁰ Use of an industry-wide productivity offset emulates a competitive market outcome. See SWBT Comments in CC Docket No. 94-1, filed May 9, 1994, pp. 36-37.

⁴¹ The Commission's third "middle" track retained earnings sharing, adopted more stringent rules on how reported earnings were to be calculated, increased the productivity offset (over the prior plan) by 1.4% per year. This track, however, was viewed by the price cap LECs as always inferior to at least one of the other two tracks, making the plan essentially two tracks.

typically used as "buffer zones" around target rates of return and monitoring periods were two years.⁴² The Commission viewed ROR regulation with buffers and longer monitoring periods as inferior to incentive regulation.

ROR regulation (or sharing) is the wrong form of regulation to be using as competition emerges, because it thwarts the ability of the regulator to remove services from price cap regulation as relevant markets become sufficiently competitive and should be subject to either streamlined regulation or nondominant treatment.⁴³ Sharing also curtails the incentives for LECs to offer new services, and thus, the Commission should not attempt to use sharing as an incentive mechanism.⁴⁴

Consistent with the goals of price cap regulation in general, price cap LECs should be exempted from any remaining Part 65 rate of return (ROR) monitoring rules and any requirement to target the prices of any interstate services to specific rates of return. Specifically, upon the application of a permanent price cap plan without earnings sharing, local exchange carriers should be exempted from Part 65.600(d) of the Commission's Rules. Also, no LEC subject to price cap regulation should be required to set rates for services excluded from

⁴² See, e.g., Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Report and Order, CC Docket No. 84-800, Phase I, (released September 30, 1985), paras. 9 and 15-17.

⁴³ See SWBT Comments on Second FNPRM, filed December 11, 1995, pp. 54-73.

⁴⁴ As explained above, sharing has no place in the permanent price cap plan nor in any reasonable incentive regulation. For these reasons, the Commission should not adopt NYNEX's proposal, nor should it include any sharing mechanism in the permanent price cap plan, whether related to the level of competition or not, as raised by issues 20 a-b of the Second FNPRM, and designated for response with the Fourth FNPRM in the Order on Motion for Extension of Time, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, (DA 95-2349) (Com. Car. Bur. released November 13, 1995).

price cap regulation pursuant to Part 62.42(f) using the authorized ROR for ROR LECs. The Commission should eliminate Part 65.1(b)(3) which causes ROR rules to apply to price cap excluded services.

The Commission should also eliminate the monitoring requirements for the calculation and submission of interstate rate-of-return data from price cap LECs. Specifically, the quarterly submission FCC Report 43-01, ARMIS Quarterly Reports should be eliminated since there remains no need for quarterly reporting from price cap LECs. Also, to the extent the ARMIS 43-01 is retained as an annual report, lines 1910 through 1935 should be eliminated entirely. These lines are only used to calculate ROR for ROR regulation or sharing.⁴⁵

From the FCC Report 43-04, ARMIS Access Report, all cost allocations not used in the interstate ratemaking process should be eliminated. Specifically, the following columns should be eliminated or populated as "N/A" for price cap LECs: Pay (column e); Common Line Inside Wire (f); BFP (g); Total Common Line (i); Switching (j); Equal Access (k); Transport (l); Total Traffic Sensitive (n); Special Access (o); Total Access (p); Billing and Collection (q) and IX (r). Since none of these cost allocations would affect rate development or price management of the services offered by price cap LECs, the reporting of such cost allocations should be eliminated.

The requirement to file the FCC Form 492a, Price Cap Regulation Rate of Return Monitoring Report (used to calculate sharing) should also be eliminated upon adoption of a

⁴⁵ Actually these calculations cannot even be used to calculate sharing because of differences between the ARMIS 43-01 and the Form 492a.

permanent price cap plan without earnings sharing. The Commission should also examine the need to reduce or eliminate other reporting requirements.⁴⁶

Issue 5b:

If we use sharing as an incentive mechanism, what sharing requirements should be associated with those X-Factors for which sharing is required? How should we structure sharing bands?

As discussed in SWBT's responses to Issues 4 and 5a above, sharing should not be a component of the permanent price cap plan. Sharing acts as a strong disincentive that is contrary to the incentives for increased efficiency necessary for a successful permanent plan. Multiple "options" for an individual LEC are not necessary. If options are adopted, they should be assignments among broad groups of LECs. In any case, no plan should include earnings sharing.

Issue 5c:

If we establish a plan in which LECs have a choice of X-Factor, how much flexibility should LECs have to change their choice? Should we continue to allow annual selection?

The ability to shift between multiple options for an individual LEC is not an essential component of the permanent plan.⁴⁷ However, some flexibility to shift between "options" (possibly on an annual basis) would be necessary if options are mandated by the Commission.

⁴⁶ The FCC Reports ARMIS 43-05, 43-06 and 43-07 regarding service quality reporting and infrastructure monitoring have served any purpose that might have been appropriate and should now be eliminated. The Commission has found that the introduction of price cap regulation has had no adverse service quality or infrastructure development consequences. (First Report and Order), paras. 62-63. The price cap LECs should be relieved of these reporting requirements.

⁴⁷ See SWBT's response to Issue 4 above.

Issue 5d:

Instead of allowing LECs to choose among several X-Factors, should we establish criteria and procedures by which we can assign an appropriate X-Factor to each LEC?

As described in SWBT's response to Issue 4 above, SWBT could support an assignment of X-factors that classifies LECs into two categories by size. SWBT is opposed to any other means of assigning X-factors.

Issue 5e:

To what extent and under what conditions would it be possible to eliminate the sharing mechanism from the long-term price cap plan?

The establishment of an X-factor using a moving average of industry TFP results will provide the proper basis for the elimination of sharing and the low-end adjustment. The X-factor would be determined by an adaptive mechanism -- a rolling average -- which ensures that the gains experienced by the price cap LECs are flowed through fully to access customers with a lag. The use of an industry average X-factor is necessary so that firms have the necessary incentive to beat the industry average. A lag in the speed with which gains are returned to customers is necessary to provide firms the ability to retain the financial benefits of superior performance, if such performance materializes.

Issue 5f:

Should the low-end adjustment mechanism be eliminated?

All ties to ROR regulation should be eliminated. This includes the elimination of specific rate levels based on revenue requirements (i.e., EUCL), earnings sharing and the low-end adjustment, and monitoring of earnings.⁴⁸ In the event that the Commission retains

⁴⁸ See SWBT's responses to Issues 4 and 5a above.

sharing in some aspect of the permanent plan, the retention of the low-end adjustment together with sharing adjustments maintains the symmetric relationship of providing earnings adjustments at the lower and the higher ends of a ROR-regulation form of regulation. However, SWBT opposes the retention of these ROR-regulation components.

M. Common Line Formula

Issue 6a:

Under what circumstances would the adoption of a particular X-Factor method justify elimination of a separate common line formula?

The different treatment of demand growth in the separate Common Line price cap index formula and the associated maximum CCL rate formula (as an alternative to the typical API calculations used in all other baskets) should be eliminated. Use of TFP results already incorporates the full productivity effects of growth in Carrier Common Line (CCL) minutes of use. The TFP approach incorporates the effects on productivity of all demand growth, including CCL, and all costs, including any and all costs that may be associated with CCL output growth.

Because demand growth is fully reflected in TFP growth, the additional demand adjustment currently included in the price cap index formula for the Common Line Basket should be eliminated. Then, the maximum CCL rate formula should be replaced with an API formula, making the price cap index formula and API calculation in this basket identical to other baskets.

The Fourth FNPRM asks whether End User Common Line rates (EUCLs) for price cap LECs should be calculated on historical or projected revenue requirements calculations.⁴⁹ Neither answer is correct. The Commission should adopt price cap rules that

⁴⁹ Fourth FNPRM, para. 137.

would permit the EUCLs to be price cap managed. The Commission should then, in a separate proceeding, examine the need to increase EUCLs as a means of reducing the implicit support provided through CCL charges. The Commission should have the authority to abandon the cost-based ROR regulation concept of revenue requirements used to determine EUCL rates.

Future Commission proceedings may consider: the extent to which EUCLs can and should be increased above the current \$3.50 and \$6.00 caps on EUCLs; the recovery of CCL revenue from bulk billing to IXC's based on presubscribed lines or other competitively neutral means; zoning or otherwise deaveraging CCL rates and/or EUCL rates; and other reforms that may affect Common Line rate structure and recovery. The adoption of SWBT's proposal for revised and simplified price cap index and API rules for the Common Line basket would facilitate these considerations. Without this price cap index simplification, the existing Common Line PCI formula and maximum CCL rate formula could and most probably would thwart more important and far-reaching rate recovery reform. This proposal is a relatively straight-forward change to the price cap mechanics that should be made to pave the way for the future.

Issue 6b:

Assuming we decide to retain a separate common line formula, should we adopt a per-line common line formula or some other formula? What should the mechanics of that formula be?

A per-line price cap index formula should not be adopted. The TFP approach already completely captures all of the effects on productivity growth of the per-minute recovery of non-traffic sensitive (NTS) costs from CCL rates and the extent to which NTS costs either grow in direct relationship to line growth or in fact grow faster or slower than line growth. The

effects of CCL rate recovery versus NTS cost growth is an empirical issue that cannot be addressed with anecdotal evidence.

SWBT recommends herein a number of related changes to the Common Line basket price cap mechanics. These mechanics should be modernized and should facilitate the future revisions to Common Line rate recovery and EUCL charges. Such revisions can and should result from the Commission's deliberation of these issues in related dockets in the near future.

The price cap mechanics must be revised in this proceeding. If the Commission fails to do so, subsequent reforms in Common Line rate design, cost recovery and implicit subsidy mechanisms will be thwarted or completely mitigated by outdated Common Line price cap rules.

Issue 6c:

Should carrier common line rates be based on historical rather than forecasted data for end user common line revenues?

CCL rates should be price managed by price cap indexes that do not utilize revenue requirements data or other cost-based forms of regulation. The Fourth FNPRM apparently believes that use of historical EUCL revenues would be somewhat more consistent with the use of base period demand and end-of-period price data in the computation of APIs and SBIs for other baskets. However, in such a case, the EUCL revenues are, in effect, determined using Part 69 revenue requirement calculations.

In the Common Line basket, if the revenue requirement calculations used to determine the EUCL rates indicate that a price cap LEC should receive additional EUCL revenues, the price cap constraints in the Common Line basket cause a dollar-for-dollar

reduction in Carrier Common Line (CCL) rates.⁵⁰ While puzzling, it is a fact that if Part 69 rules allow a price cap LEC to raise EUCLs, Part 61 price cap rules remove any and all of that intended financial benefit. The Commission should abandon use of Part 69 Rule revenue requirements calculations (using either historical or prospective revenue requirements) for determination of EUCL rates for price cap LECs. This would also eliminate the use of the EUCL Part 69 revenue requirements in the calculation of CCL rates for price cap LECs. It would not, however, provide any additional "headroom" for LECs because EUCL rates would be capped by the "dollar caps" in Part 69.

SWBT recognizes that the Commission cannot change the dollar caps on EUCL rates contained in Part 69 rules, (i.e., the \$3.50 cap on residence and single-line business and the \$6.00 cap on multi-line business) in the context of this proceeding. These "dollar caps" would for now remain the effective price cap constraints on EUCL rates in the Common Line basket. The maximum CCL rate formula should be eliminated and replaced with an API method that is essentially identical to the methods used in other baskets.

⁵⁰ An increase in proposed EUCL rates (based either on historical or prospective revenue requirement calculations) increases the subtraction of the EUCL rate per MOU used in the calculation of the maximum CCL rate formula. The result of this formula is to reduce CCL rates essentially dollar-for-dollar for each dollar of increased EUCL rate. Thus, price cap LECs are prevented today from receiving any benefit in total Common Line revenue from the increase in the revenue requirements calculations performed in order to comply with Part 69 Rules that determine the EUCL rates charged by price cap LECs. 47 C.F.R. §§ 69.104, 61.45(c) and 61.46(d), (e) and (f).

N. Exogenous Costs

Issue 7a:

Is it feasible to fashion an X-Factor that will routinely include costs currently classified as exogenous and exclude costs that the Commission has determined are not exogenous?

The effects of most exogenous cost adjustments on measured TFP results is either minimal or nonexistent. For example, exogenous adjustments for the expiration of Reserve Deficiency Amortizations (RDAs), the expiration of Inside Wire amortization, separations rules changes (including the SPF to DEM transition for local switching and the SLU to Gross Allocator transition for Common Line separations ratios) do not affect measured TFP results. Also, the economic measure of capital inputs used in the Christensen methods does not utilize booked expenses for depreciation and amortization; instead, capital input is calculated from the economic value of capital stock. In measuring labor input, the Christensen methodology utilizes physical quantities of input -- employees in the current simplified model and hours worked in the original Christensen study. As a result, any exogenous adjustments associated with wages, salaries or benefits expenses do not affect the quantity of labor inputs.

Thus, the Commission should not make adjustments to the TFP methods to "back out" amounts associated with exogenous adjustments to price cap indexes. It is not feasible or necessary to routinely classify costs among exogenous and endogenous and attempt to remove exogenous amounts.

Issue 7b:

Would it be reasonable to limit exogenous cost treatment to changes that result in a jurisdictional cost shift?

Exogenous treatment should not be narrowed to include only those changes that result from jurisdictional cost shifts. There will continue to be instances in which the Commission's mandates or other administrative actions that are clearly beyond the control of the LECs cause cost changes that need to be addressed in some form of adjustment to allow carriers to recover or flow back to customers the effects of the cost changes. Straight-forward examples of these changes include Telecommunications Relay Services (TRS) and changes in the Commission's regulatory fee schedules. Without some mechanism in this regard, such mandates or requirements could have an unlawful confiscatory effect.

O. Rescheduling of Performance Review

Issue 8:

Regardless of whether we establish a moving average mechanism to incorporate automatically changes in unit costs into the X-Factor, would it be desirable to schedule a LEC price cap performance review, and, if so, when?

The use of a moving-average X-factor will eliminate the need for frequent performance reviews. SWBT's response to Issue 3f above provides other reasons not to establish a performance review schedule.

III. CONCLUSION

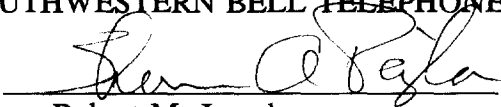
For the foregoing reasons, SWBT respectfully requests that the Commission adopt the TFP approach to set the productivity offset in the LEC price cap plan, and that other

proposals that skew the results of the TFP approach or eliminate incentives from price cap regulation should be rejected.

Respectfully submitted,

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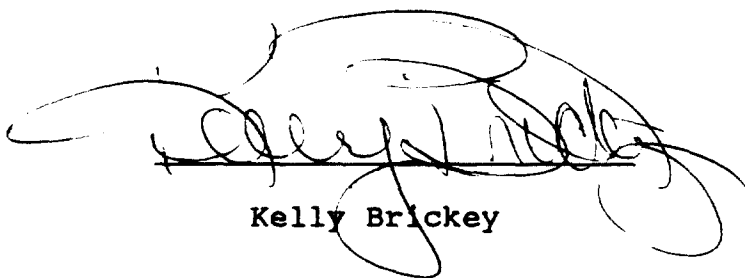
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December 18, 1995

CERTIFICATE OF SERVICE

I, Kelly Brickey, hereby certify that the foregoing "Comments of Southwestern Bell Telephone Company", in CC Docket 94-1, have been served ~~December~~ ^{January 11, 1996}, 1995 to the Parties of Record.


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~~December~~ ^{January 11, 1996}, 1995

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